Letter n°122

Tariffs. Trump against his European and Asian allies.

"Diplomacy without weapons is like music without instruments" Bismarck.

From a military perspective, Europeans, especially the Germans, now understand the meaning of Bismarck's famous words, as trust with the United States has been broken, likely for the long term.

Trump's statements have pushed the EU forward on the path of European defense, a path that had seemed doomed since the failure of the European Defense Community (EDC) in 1956. For a long time, sheltered under the American umbrella, traditional allies now find themselves somewhat unarmed in responding to Trump's threats or blackmail. Trump is demanding that the EU allocate a military budget of 5% of GDP, as he hopes for contracts for American companies. Between 2019 and 2023, 55% of the military equipment purchased by Europeans was American-made, but they are now aware of the potential for an American veto on the use of these weapons. As a result, they are increasingly likely to purchase European or Asian (excluding Chinese) equipment. On the stock market, the defense sector, where we are invested, will remain attractive, but American stocks will underperform compared to European groups.

From a political perspective, the transatlantic alliance, which has lasted 80 years, seemed eternal, but trust has been broken. Musk and Vance openly supported the AfD before the German election because the party advocated for Germany's exit from the € and the EU. With the AfD in power, it would have meant the end of a certain European vision. Trump and Musk both seek to dismantle the EU, the world's leading trade power, and to eliminate its ability to regulate the GAFAM.

Behind the demand for already-indebted European countries to invest 5% of their GDP in defense lies the intention to force cuts in social spending, at the risk of fuelling middle-class resentment and the populism that Trump favours.

After 45 days of Trump's presidency, polls show that 78% of Britons, 74% of Germans, and 69% of French people see Trump as a threat. A positive consequence of this rejection or concern is that Europe is waking up, seeking to free itself from dependence on the United States, and the United Kingdom is moving closer to the EU.

From a trade perspective, in 2024, the United States had a trade deficit in goods with nearly all its historically allied countries: $85 billion with Germany, $87 billion with Ireland, $74 billion with Taiwan, $68 billion with Japan, $66 billion with South Korea, $46 billion with India, $44 billion with Italy, $38 billion with Switzerland, and $16 billion with France. The US only had trade surpluses with the Netherlands ($56 billion, the largest US bilateral surplus), Belgium, the United Kingdom, and Spain.

From an economic perspective, the tariff increases imposed by Trump, already applied to 45% of US imports against China, Canada, and Mexico, and soon to 60% when the EU is sanctioned, are the steepest since the 1930s. These measures could push certain countries, such as Mexico and Canada, into recession and slow down the US economy.

We will first analyse the deterioration of relations with Europe, followed by the evolution of relations with Asian allies and Brazil.

Relations with the EU:

Total bilateral trade between the US and the EU reached $1.7 trillion in 2023, accounting for 30% of global trade. The US remains the EU's largest export market, ahead of China and the United Kingdom, while the EU is also the largest export market for the US.

According to Trump, the EU is an "atrocity", and he wishes for its dissolution. He accuses Europeans of hindering Silicon Valley giants with excessive regulations. He also criticises the 15% global minimum corporate tax initiative, the US trade deficit with the EU, and EU regulations against GMOs and polluting vehicles.

Trump's announced measures come at a bad time for the EU, as economic growth remains weak.

A European surplus to put into perspective:

The US trade deficit with the EU was $235 billion in 2024, but the US surplus in services was $109 billion in 2023. After factoring in investments, the overall balance is almost even, at -$23 billion in 2023.

More importantly, to truly assess the depth of US–Europe ties, it's worth noting that sales by US firms operating in Europe reached $3.8 trillion in 2022, which is more than four times the value of US exports to Europe.

Europe's often underutilised strengths:

For years, the United States has been playing its own game, with policies like Biden's IRA and the semiconductor plan serving as key examples. However, Trump's cuts to public research funding and university financing could create an opportunity for the EU to attract top researchers.

The EU still holds many advantages but fails to leverage them effectively. As the world's second-largest economy, on par with China, the EU has a 450-million-strong market, a skilled workforce, and a high standard of living. As seen during the COVID-19 crisis and Russia's invasion of Ukraine, the EU must once again demonstrate its resilience and ability to rebound.

Traditionally a strong advocate of free trade, the EU remains the world's leading trade power, with its trade volume representing 30% of its GDP, compared to just 22-25% for the US. Today, both the US and China are vying for access to the European market.

European political concerns:

The tariffs imposed by the EU on American products amount to 4.5% on average, and only 0.9% on a weighted average, according to the WTO.

Concerned about the survival of their industries, Europeans, especially major countries, are embracing protectionism, while smaller countries remain in favour of open borders.

For now, Europeans appear stunned by Trump's announcements.

The EU is worried about Trump, whether it be a withdrawal of US aid within NATO, a pull-out of 100,000 American troops stationed in Europe, or the imposition of tariffs.

It is ironic to hear Vance denounce a lack of free speech in Europe, which he considers a greater threat than Russia, while he still disputes the results of the 2020 US election, while Trump has shamelessly pardoned those involved in the Capitol attack, while the new administration, forgetting Tocqueville and Montesquieu's principle of separation of powers, seeks to eliminate checks and balances, particularly judicial oversight, and to establish the tyranny of the majority, however narrow it may be, 51.5% of the vote in the presidential election, only 53 Senate seats for a majority of 51, and 219 Congressional seats for a majority of 216.

Weakened by the rise of the anti-European far-right, and divided by the pro-Putin and pro-Trump positions of populist leaders such as Orbán and Fico, the EU struggled to speak with one voice, but last week, the ambitious defense plan was adopted unanimously.

European economic concerns:

- ***Concerns about steel and aluminium:***

Two sectors to avoid in the stock market, as the 25% tariff on steel and aluminium comes at a bad time for European industry, which is already weakened by the energy cost gap with the US, the slowdown in the automotive and construction markets (which together account for about 50% of demand) and low-cost Chinese competition (27% of the steel consumed in Europe now comes from China, up from 15% in 2019).

While steel exports were 29 million tons in 2014, they had dropped to 16 million in 2023.

Exports account for 13% of European production, and one-quarter of these exports, just over 3% of European production, is destined for the US. These new tariffs will likely make trade even more challenging.

- ***Threats to the automotive sector:***

A potential increase in automobile tariffs is under discussion, as US cars exported to the EU face a 10% tariff, whereas European cars sold in the US are taxed at only 2.5%. It seems that the EU might align its tariffs to 2.5%. If not, German automakers, who employ 800,000 workers in Germany, would be the main victims. While they produce 900,000 vehicles in the US, they also export 400,000 and operate subsidiaries in Mexico.

- ***Concerns about VAT and the digital services tax being classified as trade barriers:***

The United States wants to include VAT in the calculation of European tariffs, arguing that American products are subject to VAT upon entering the EU. Since the average VAT in Europe is 22%, compared to a 7% consumption tax in the US, this could disadvantage European products. However, Trump overlooks the fact that, in the domestic European market, all products, regardless of origin, are subject to the same tax.

Additionally, the US wants to include targeted taxes, such as the digital services tax in Canada and France, and non-tariff barriers, such as the fines imposed on GAFAM.

Lastly, the US aims to eliminate European regulations that enforce content moderation and competition rules on GAFAM.

Germany at a crossroads:

To counter the slowdown in sales to China, Germany has focused on exports to the United States. In 2023, the US was Germany's largest customer, accounting for 10% of German exports (€151 billion), with a trade surplus of €63 billion, mainly in pharmaceuticals, automobiles, and industrial machinery.

Today, Germany is Trump's primary European target, even though the US offsets part of this trade deficit with a surplus in services. With the threat of higher tariffs, many are concerned about a third consecutive year of recession.

From a budgetary perspective, Germany has low debt (63% of GDP). If it had invested as much in defense as France over the past 25 years, its public debt would now exceed 80% of GDP. The election of Merz and his plan to implement a €500 billion, four-year programme focused on infrastructure renewal and defense sector revitalisation could positively change the situation.

From a stock market perspective, construction, electric energy, and defense remain key areas of interest. Rheinmetall, a manufacturer of armoured vehicles, artillery systems, and munitions, has been one of the biggest winners, with its stock appreciating 94% this year.

The Draghi report paints a stark picture of Europe's economic decline. Von der Leyen has emphasised the need to ease regulations, and the implementation of common policies in defense, digitalisation, capital markets, and energy has become an imperative.

Relations with other Asian allies and Brazil:

Japan:

The Japanese are worried. They host 54,000 US soldiers, already fund 70% of their costs, and have committed to raising their military budget to 2% of GDP by 2027, compared to the current 1%, but they fear that Trump will impose a military budget of 3% of GDP.

Japan is targeted by the 25% tax on automobiles as it exports 1.4 million cars to the US.

From a stock market perspective, there is caution regarding Japanese export companies, although Japan could use Treasury bonds as leverage, as it is the largest holder, with over $1.2 trillion.

India:

India is criticised for overprotecting its borders, with excessively high tariffs that deter American product imports.

Philippines:

Philippine President Ferdinand Marcos, in contrast to his predecessor Duterte, who was pro-China, is pro-American and does not need to fear US backlash, as the archipelago plays a crucial role in countering China's influence in the Pacific.

South Korea:

South Korea is concerned about the proposed 25% tax on automobiles as it exports 1.5 million cars to the US.

Trump also wants to impose a 25% tax on semiconductors. In 2024, South Korea exported $10.5 billion worth of components to the US, so companies like Samsung will be closely monitored.

Brazil:

While China is Brazil's largest trading partner, the US is its second largest. American products sold to Brazil are taxed on average at 11%, while Brazilian products exported to the US are taxed at only 2%.

Trump seeks symmetrical tariffs and has already announced 25% tariffs on Brazilian steel and aluminium. This issue is significant because half of Brazil's steel is exported to the US, and Brazil is the second-largest supplier to the US.

Conclusion: ***"Politics is the art of agitating the people before using them." Talleyrand.***

Trump could very well be a reader of Talleyrand. He stirs up many people, but it is still early to know if anything concrete will come out of his multiple provocations.

In the meantime, and this is very positive, he has succeeded in awakening the EU, Japan, and South Korea, all of whom are now backed into a corner regarding their defense.

Meanwhile, we observe a fourfold uncertainty:

- ***Political uncertainty***:

Trump and Vance in Europe, could decide to withdraw their troops from NATO and play the extreme right card, as they are in favour of dismantling the EU, making Europe no longer a commercial power. The EU is thus contaminated by Trumpian rhetoric, as evidenced by extreme right speeches against foreign aid, criticism of environmental measures, and the anti-migrant hardening.

This aggressive stance not only targets the EU but all allied countries, encouraging nations to move closer together. For instance, the EU has recently signed 3 trade agreements: one with Mercosur countries, another with Switzerland, and a third with Mexico, while also moving closer to India. Meanwhile, Indonesia, historically aligned with the US, has joined the BRICS, which Trump despises.

- ***Commercial uncertainty***:

No one understands the reason behind the use of tariffs as a weapon. Is it to find revenue to finance tax cuts? If so, very significant increases would be needed. Is it to reindustrialise the country? If so, there is a lack of targeting of specific sectors. Is it to negotiate for concessions? If so, in the long run, there will be no tariffs, and thus tax cuts won't be financed, which will lead to a sharp increase in public debt.

- ***Uncertainty for businesses***:

Exporting companies would be the losers if export volumes decline due to price increases or if they need to compress their margins.

Another important variable is exchange rates, whose fluctuations, which have been significant recently, can either reduce or increase the cost of tariffs.

- ***Market uncertainty***:

Among Western countries, aside from the specific stocks already mentioned, the most affected stocks on the market are those of export companies.

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